Commentary

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STAYING ON COURSE

Summary: The federal government has made a good start in identifying and dealing with the priority issues for economic policy. But the individual policy initiatives still are not pulled together to form an overall strategic framework. The government now faces the double challenge of staying on course, in spite of a highly politicized climate, and of clearly articulating the overall thrust of its policies. The common theme is to increase the economy's flexibility in responding to rapid changes in the international environment. It is toward this end that a continuing program of deficit reduction, a prospective tax reform, an effective regional policy, and a concurrent effort for multilateral and bilateral trade liberalization should be directed.

The federal government is now in the third year of its electoral mandate -- a period when, as Samuel Johnson would have put it, the prospect of going to the polls concentrates the political mind wonderfully. Good politics, however, need not be incompatible with good economics. Indeed, the best way for the federal government to enhance its credibility is by sound management of the nation's economic affairs.

The major issues Canada faces are not new. But there is a new sense of urgency to dealing with them. Against the background of dramatic changes in the international environment, the traditional pattern of trade-driven growth of the Canadian economy can no longer be taken for granted. Continuing growth is conditional on Canada's ability to maintain and expand access to foreign markets and, at a more fundamental level, to restructure and improve the efficiency of the economy. Thus, a real measure of the government's success is the extent to which short- and medium-term policies are consistent with, and lead toward, long-term growth objectives.

The government's record in identifying priorities over the past year or so has been good. The February 1986 budget introduced a fiscal plan to reduce the deficit and stabilize the debt-to-GNP ratio at below 60 percent by the end of the decade. Bilateral trade negotiations with the United States got under way in earnest. Serious work started on reforming Canada's tax and social transfer system. And the government appears to have recognized the need for different approaches in regional policies.

These measures constitute key elements of an appropriate strategic package. The government now must demonstrate to the public a consistent policy framework and the linkage between the individual components. The challenge, then, is twofold: first, to stay on course in spite of the pressures of a highly polit-

icized domestic environment; second, to provide leadership by clarifying the overall policy thrust and developing a broad consensus of informed opinion in support of the strategic agenda.

Fiscal Responsibility and Tax Reform

Finance Minister Wilson's recent economic update confirmed the widespread expectation that the federal deficit in the current fiscal year would exceed the projected target of $29.5 billion. While expenditures have remained in line with the February budget forecast, a revenue shortfall is now expected to produce a deficit of $32 billion.

In the Institute's assessment, this deviation from the target is acceptable, provided that the government continues to demonstrate its commitment to deficit reduction in the medium term. No single deficit number is the dividing line between responsible and irresponsible fiscal management. One can do magic with the numbers, but numbers are not magical. The essential points are that the federal deficit will continue its downward trend even in the face of slower-than-expected economic growth, that the government is in control of its spending programs, and that the finance minister is committed to take future action, if necessary.

By itself, however, the revenue shortfall gives rise to some important questions. The finance minister attributed lower government revenues to external forces, such as the decline in oil and grain prices and the slower pace of growth in the economies of Canada's major trading partners. While these factors undoubtedly have been of great importance, it is not clear that they fully account for the $1.7 billion shortfall in corporate income tax collections compared with projections contained in the 1986 budget.

It appears that the budget assumptions may have overstated the revenue-raising capacity of the current tax regime. If this is indeed the case, the credibility of the government's fiscal plan is directly dependent on a comprehensive reform of the tax system.

The prospect of reforming the Canadian tax system has attracted, and eluded, successive federal governments for the past two decades -- from the Carter Royal Commission's inquiry in the mid-1960s to the MacEachen budget of 1981. On coming to office in 1984, the Mulroney government promised an incremental approach. In its Agenda for Economic Renewal, the government sought "to examine the tax system, not only from a revenue standpoint, but in terms of its impact on growth, equity and simplicity." It also noted that there "may be merit in other changes to the tax system, which should be made on an evolutionary basis," possibly a value added tax (VAT) as a replacement for the current federal sales tax.

In light of accumulating federal debt and the political difficulty of expenditure cuts, revenue considerations remained the prime driving force behind tax measures in the 1985 and 1986 budgets. Still, the 1986 budget took a step toward reforming the corporate income tax structure by lowering rates and broadening the base through a phaseout of the general investment tax credit and the elimination of the 3 percent inventory allowance. The government also made commitments for further changes in the corporate income tax and for introducing a business transfer tax on the point-of-sale price of all goods and services.

In the immediate aftermath of the 1986 budget, the government opted for treating personal, corporate, and sales tax reforms separately, and for proceeding in all three areas in a piecemeal fashion.

Whatever timetable the government may have had in mind for the incremental steps, it was certainly disrupted by the unexpected progress of tax reform legislation in the United States. In a series

of dramatic moves, both Houses of Congress and the administration hammered out a tax package that will become law in the new year. The United States followed a comprehensive approach; in so doing, it delivered a politically attractive combination. The new law will simplify the system, cut personal taxes, place greater burdens on corporations, and eliminate many exemptions favoring special interests. And it will achieve all that in a "revenue-neutral" manner -- that is, without significantly affecting the total federal tax take.

The U.S. tax legislation has created pressure on the Canadian federal government to follow suit. Two sets of arguments have been advanced. On economic grounds, it is said that failure to emulate the U.S. example would result in a flight of capital, and possibly a "brain drain", in search of more favorable tax treatment in the United States. On political grounds, the popular appeal of the U.S. measures is thought to be precisely what is needed in Canada to shore up the government's support in opinion polls.

While the Institute favors a comprehensive tax reform, in our view Canada should make haste slowly. A headlong rush to produce comprehensive reform is likely to result in a flawed system. We have three basic reasons for suggesting an evolutionary, rather than a radical, approach; all three reflect a recognition of deep-seated differences between the tax systems and the underlying economic, social, and political conditions of the two countries.

First, the United States has placed the burden of fiscal responsibility on the mechanical application of the Gramm-Rudman legislative limits on budget deficits. In the Canadian context, however, the responsibility is on the shoulders of the federal government, which can, and should, exercise discretionary judgment year by year. Thus, the government must bring its long-term fiscal plan in line with the capacity of a reformed tax system to deliver the required revenues. Unlike the U.S. federal government, the Canadian federal government is not in a position to act alone but must take into account, among other things, its role in collecting taxes for, and making fiscal transfers to, the provinces. A comprehensive tax reform, therefore, must give full consideration to federal-provincial issues.

The second reason for a slower approach is the difference between Canadian and U.S. attitudes and values regarding the role of government in society. Canadians expect that, in one form or another, the government will maintain a basic "safety net" of income support programs and provide a range of supplementary benefits in case of particular hardships. At present, linkages between the two combine to distort incentives and increase dependencies. The personal income tax component of any tax reform package must be consistent with measures in any social policy reform package. The integration of tax and social policy provisions is an important undertaking, without any parallel in the United States.

The third reason relates to differences in the potential scope of benefits from a comprehensive tax reform. Because of the structure of the Canadian tax system, the kinds of measures implemented in the United States would not be revenue neutral here; rather, they would result in significant shortfalls. Thus, in addition to income tax changes for individuals and corporations, some form of VAT would have to be incorporated in the Canadian reform package. While shifting the tax burden away from income and toward consumption would create room for reduced personal tax rates, implementing such a scheme would create difficult technical and transitional problems. Here, too, the complications are greater than in the United States.

These observations, to be sure, do not negate the strong case for a compre-

hensive Canadian tax reform. They merely underscore the importance of careful planning and the need for gradual progress.

A particularly sensitive aspect of a tax reform, as noted earlier, is its integration with a long-overdue reform of Canadian social programs. Sweeping changes in the system of transfers to individuals were recommended by, among others, the Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission), which proposed to replace most of the existing components with a single Universal Income Security Program (UISP). The UISP would be, in effect, a guaranteed annual income scheme, combining a relatively low income-guarantee floor with a moderately low benefit-reduction rate as the recipient's income rises. Together with a set of changes in unemployment insurance, the Macdonald Commission's recommendations were intended to reduce disincentives to work, while maintaining a safety net of basic income security.

The Institute's assessment of these recommendations suggests that the Macdonald Commission may have been overly optimistic in its calculation of the cost of such a single, universal program -- that its proposals do not take into account the degree of flexibility required in light of regional differences.

Instead, the proper context is an integrated tax and social policy reform. It is the tax and transfer systems taken together that create incentives and influence the economic decisions of individuals and firms. Both systems face three challenges: to live within constraints imposed by the limited fiscal capacity of governments, to deal with pressures from society to allocate costs and benefits equitably, and to improve economic efficiency. (A forthcoming Institute study examines these considerations in detail, but underlying the analysis is a desire to seek a balance between fiscal, social, and economic responsibilities, and, as a corollary, to ensure that scarce resources are used more effectively and efficiently.)

Regional Policies and Economic Adjustment

Of all the long-standing issues on the horizon, regional disparity is perhaps the oldest. Reviewing the historical evidence, the Macdonald Commission noted:

> Regional policy has defied our best effort to devise an appropriate management framework. There has been constant debate about the level of government that should design and implement programs, the criteria of judging need, and the appropriate link between regional policies and more general economic initiatives, such as stabilization or transportation policy. We appear to have spent nearly as much time arguing about how to implement measures that were doomed to failure as we have in searching for new solutions.

While there is truth to these comments, the endless debates and continuous searching for solutions have not been completely in vain. At the very least, we have learned two important lessons about the nature of disparities and the potential scope or limitations of various public policy options.

The first lesson is that regional disparities are rooted in the structural characteristics of the economy. Hence, the most effective way to reduce interregional differences is through changes in the composition and organization of economic activity in various parts of the country. Since perfect flexibility is impossible and even partial adjustment is a slow and painful process, the practical objective of a regional policy should be to remove, as far as possible, the impediments to structural change and to assist the natural, market-responsive, course of adjustment.

The second lesson is that cyclical factors, usually international in origin, may aggravate or alter the disparities. Cyclical developments tend to have different effects on different regions. The so-called big levers of macroeconomic policy are notoriously inadequate in dealing with regional differences. In fact, some monetary and fiscal measures that are appropriate from a national perspective may prove to have adverse effects on individual regions and accentuate cyclical problems. Thus, an essential component of regional policies should be to cushion, on a temporary basis, the effects of sharp or prolonged cyclical fluctuations.

Facilitating long-term adjustments, yet cushioning the impact of shocks on individuals, constitutes the essence of what might be called "confederation economics". The underlying principle here is regional fairness. A recent Institute study, New Stresses on Confederation, emphasizes this point. In recommending temporary assistance to maintain the incomes of those hardest hit by cyclical change, the study argues that such policies should be symmetric. Specifically, "if resource-consuming provinces are cushioned when commodity prices boom, resource-producing regions should be cushioned when commodity prices slump. This principle -- of which westerners are acutely aware but which central Canadians seem to ignore when resource prices are falling -- should be central in designing an appropriate response to the recent collapse in oil and grain prices."

This study of diverging regional economies draws a sharp distinction between (a) shielding industries in general from the effects of changes in world market conditions, and (b) providing temporary and targeted assistance. The distinction is illustrated by contrasting two sectoral policy options in connection with the plight of the petroleum industry. The first option would have been to re-establish a variant of the national oil policy of the 1960s and hold oil prices in Canada above the world level to ensure a continuing domestic market for western producers. The federal government, quite appropriately, has rejected this option so far. Instead of creating an artificial shield, the federal and provincial governments have adopted a correct approach by temporarily reducing royalties and lowering taxes on oil production.

The removal of the Petroleum and Gas Revenue Tax (PGRT) brings into focus questions that are central to the concept of confederation economics: regional fairness and regional adjustment. The tax was imposed during the resource boom of the 1970s to capture for the national treasury a portion of the economic rents generated by the rapid rise in world prices. It was, in essence, a transfer of producer surplus to the consumer and could be justified accordingly. When the rents disappeared with the precipitous fall in oil prices, the tax remained in place, although the federal government agreed to a gradual phaseout. Retaining the PGRT violated the principle of fairness.

While eliminating the PGRT was a correct response to reduced sectoral growth prospects in Western Canada, a general review of regional assistance programs is still needed. The emphasis often appears to be on providing subsidies to manufacturing industries in Central Canada, where growth momentum presently is strong and, if anything, some early signs of an overheating economy may be apparent. Subsidies and incentives to the healthy areas and sectors of the Canadian economy are unjustified; they represent a drain on scarce federal resources and are inconsistent with the government's commitment to foster economically viable development.

The federal government risks increasing these distortional subsidies if it allows its vision to be clouded by electoral considerations and follows the discredited practice of pouring funds into doubtful "job-creating" regional development projects. In the Institute's

view, the appropriate policy is to provide temporary assistance to the cyclically depressed sectors of Canada's "other economy", cushioning in the short term the impact on individuals, yet supporting long-term structural readjustment.

Trade Negotiations in Perspective

Bilateral talks are no longer "the only game in town" for trade negotiators. To the surprise of many observers, some 70 countries at the recent General Agreement on Tariffs and Trade (GATT) conference at Punta del Este, Uruguay, agreed to an agenda for the "Uruguay Round" of global trade negotiations, beginning immediately and concluding within four years. Since the GATT effort potentially could breathe new life into the multilateral trading system, it is appropriate to ask: Will Canada's bilateral and multilateral negotiations complement each other, or will they be in conflict?

In the Institute's view, not only are the two sets of negotiations complementary, they are essential if Canada is to achieve its international trade objectives. As the Institute concluded in Taking the Initiative: Canada's Trade Options in a Turbulent World, published last year, "the only chance for the major changes that are needed in our trading relations lies in bilateral trade liberalization with the United States -- pursued in conjunction with, not as an alternative to, multilateral negotiations for trade liberalization."

The Punta del Este agreement has altered the context of the ongoing Canadian-U.S. trade talks in two respects. First, it significantly changes the strategic importance of a bilateral agreement for the United States. Second, it narrows somewhat the scope of negotiating areas between the two countries.

Ever since the federal government initiated the talks, the debate in economic and political terms has been far more extensive in Canada than in the United States. This is hardly surprising. The stakes for Canada are much higher, whether the potential opportunities or the potential risks are considered. In addition, the prospect of closer bilateral links touches on the sensitive question of Canadian national identity.

In the context of the Uruguay Round, a bilateral agreement with Canada could become a key component of U.S. international trade strategy. Through a series of compromises achieved at Punta del Este, GATT members agreed to place on the global negotiating agenda such issues as trade in agricultural products, intellectual property rights, investment flows, and trade in services. All of these subjects have been on the United States' "must" list for several years, but have been strongly resisted by other countries for a variety of reasons. In fact, the disagreement between industrial and developing countries on the one hand, and among the industrial countries themselves on the other, resulted in the breakdown of an earlier attempt in 1982 to begin a new round of GATT negotiations.

Placing these items on the agenda is one thing, achieving success in international talks is another. Since many of the contentious issues that will come up in the course of the Uruguay Round are also likely to be included in the Canadian-U.S. bilateral negotiations, the outcome of the bilateral talks could have a major impact on the negotiating posture of other GATT members. It is now clearly in the interest of the United States to reach some form of agreement at the bilateral level that demonstrates to the world a degree of flexibility in the U.S. position, without setting a precedent that would tie the hands of U.S. negotiators in the forthcoming global talks. For both Canada and the United States, the compatibility of bilateral and multilateral approaches is an essential precondition of success.

With respect to the scope of negotiating areas, the Uruguay Round opens up the possibility of concluding a partial

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bilateral agreement that leaves the door open for further talks in the multilateral context. Two specific subject matters might fall in the category of unfinished bilateral business: agricultural trade and trade in services. In the case of farm products, many of the problems in Canadian-U.S. trade are a fallout from the broader problem of the export subsidy and farm support programs of the European Economic Community's agricultural policy. Hence, it is logical to seek solutions as quickly as possible as part of the future GATT negotiations. In the area of trade in services, an opportunity now exists to confine the bilateral talks to defining some broad principles for bilateral trade and to negotiating specific rules in subsectors where the interests of both countries can be balanced. The Punta del Este ministerial declaration, for the first time in the history of the GATT, includes services and sets out the goal of drafting broad rules and enforcement procedures on a multilateral basis. Thus, the United States might be less insistent on seeking comprehensive treatment of the services sector in bilateral talks.

The Punta del Este agreement does not mean that the world is any closer to an effective international trading system or that the prospect of trade wars and further protectionist sentiments is going to diminish. But the danger of a complete breakdown -- a real threat in the current environment -- has been averted, at least for the time being. From a Canadian point of view, the particular significance of the forthcoming Uruguay Round is that it lays to rest the myth that Canada cannot pursue bilateral and multilateral negotiations at the same time.

Conclusion

In the first two years of its electoral mandate, the federal government has made progress on many economic issues and has begun to face some of the fundamental and long-standing problems of the Canadian economy. But the individual components of the strategic framework do not come together. The challenge now is to focus public attention on the interdependent nature of various policy initiatives. Fiscal responsibility is credible only if it goes hand in hand with tax reform, while tax reform and social policy changes are inextricably linked. Within a strategic framework, the federal government can assist sectoral and regional adjustments by removing barriers to change and by taking temporary cushioning measures. Overarching these domestic policies should be the concurrent pursuit of bilateral and multilateral trade liberalization. Staying on course offers the best opportunities for the long-term growth of the Canadian economy.

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